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Ad Hoc Working Group on Investment and Financial Flows; Non-debt-creating Finance for Development; New Mechanisms for Increasing Investment and Financial Flows
Third session
Geneva, 10 January 1994
Agenda item 7

DRAFT REPORT OF THE AD HOC WORKING GROUP ON INVESTMENT AND FINANCIAL FLOWS; NON-DEBT-CREATING FINANCE FOR DEVELOPMENT; NEW MECHANISMS FOR INCREASING INVESTMENT AND FINANCIAL FLOWS ON ITS SECOND SESSION

Held at the Palais des Nations, Geneva,
from 10 to 14 January 1994

Rapporteur: Mr. E. Mercado (Mexico)

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INTRODUCTION

1. The third session of the Ad Hoc Working Group on Investment and Financial Flows was held from 10 to 14 January 1994 at the Palais des Nations, Geneva.

2. In the course of its session, the Ad Hoc Working Group held ... plenaries and ... informal meetings.

Chapter I

PORTFOLIO EQUITY INVESTMENT AND NEW FINANCING MECHANISMS

(Agenda item 4)

3. For its consideration of this item, the Ad Hoc Working Group had before it the following documentation:

"Foreign portfolio equity investment in developing countries: current issues and prospects - report by the UNCTAD secretariat" (TD/B/WG.1/11);

"Capital markets, foreign portfolio investment and economic development (UNCTAD/GID/DF/4) (background document);

"Report on private financing of infrastructure projects in developing countries, with special emphasis on build-operate-transfer (BOT) arrangements" (UNCTAD/GID/DF/5) (background document).

Seminar on portfolio equity investment and new financing mechanisms held during the session

4. During the Group's third session, a three-day seminar-type discussion took place on agenda item 4 led by invited panellists who made presentations and responded to questions on the following topics:

(a) Foreign portfolio equity investment in developing countries and countries in transition:

(i) Factors determining portfolio equity flows;

(ii) Policy issues: the role of stock markets; improving standards of emerging markets; macroeconomic and financial impact of foreign portfolio equity investment;

(iii) Prospects for portfolio equity flows: the role of host and home countries;

(b) Private financing of infrastructure projects in developing countries, with special emphasis on build-operate-transfer (BOT) arrangements:

(i) The costs and benefits of BOTs;

(ii) Problems of implementation and prospects for developing countries.

5. Following the presentations and discussions, the **Chairman** summed up the conclusions to be drawn (see paras. 6 - 29 below).

Chairman's summing up of seminar discussions

Foreign portfolio equity investment in developing countries and countries in transition

Factors determining FPEI flows

6. The upsurge in the flows of FPEI to emerging markets has been driven by factors specific to those markets, as well as by the global economic environment, particularly low international interest rates. International investors, aiming to maximise returns and minimise risk, have found that emerging markets offer attractive risk-adjusted returns, as well as the opportunity of diversifying portfolios.

7. Host country factors which have been crucial for investors' decisions to hold portfolios in an emerging market fall into three groups:

(1) The degree of political and macroeconomic stability;

(2) The host country's commitment to the process of economic and financial liberalization and reform;

(3) The state of development of the host country stock exchange and the institutional and regulatory framework. The following variables were found to be important: size of the local stock market, number of listed companies, liquidity, number of participants, investor protection (such as insider trading regulations), enforcement of regulations, and volatility.

8. In addition, a number of other technical factors which might act as an obstacle to FPEI were identified. These are:

- Absence of a reliable and timely settlement system;
- Periodic closing of the stock exchange;
- Lack of information on quoted stocks;
- Absence of hedging instruments, in particular on currencies, the stock exchange index, and specific securities;
- Lack of a reliable and transparent accounting and auditing system.

9. Large discrepancies between various estimates of FPEI flows to emerging markets were observed. This made it difficult to conduct a reliable analysis of FPEI flows. It was felt that this was mainly due to unsatisfactory data collection by host countries, which were invited to improve their data recording on foreign portfolio equity investment, especially foreign direct purchases in local stock markets.

Policy issues

(a) The role of stock markets

10. Stock markets and financial intermediaries, such as banks, are complementary in mobilizing resources for corporate financing. Stock markets help reduce the cost of raising risk capital, improve the allocation of resources within the economy and enhance firms' financial structure. Stock markets, and in particular second-tier markets, are an efficient source of finance for small and medium-sized companies, although their listing opportunities are limited in many emerging markets.

(b) Strengthening of local stock markets

11. The strengthening of local stock markets requires the development and broadening of the domestic investor base and the establishment of a healthy private sector. In this respect, three points emerged during the discussion:

- Privatization has a role to play in broadening emerging markets and in adding liquidity, particularly for countries in transition;

- A prudent regulatory framework will ensure investors' confidence in the stock market. The purpose of regulation should be to provide adequate investor protection, especially for minority shareholders.

A balance should be found between self-regulation of the stock market and direct government intervention. Regulation and surveillance of the market should secure adequate disclosure and transparency;

- Stock market reforms to improve the transparency and efficiency of price dissemination are also recognised to be necessary. In parallel with these reforms, measures should be introduced to strengthen brokerage activities, such as those concerning minimum capital requirements of brokerage houses.

(c) Macroeconomic and financial impact of FPEI

12. FPEI, like any other form of capital inflow, could induce a real appreciation of the exchange rate and reduce the host country's control on monetary policy. However, in most countries, FPEI so far has had a negligible impact on these variables, as the amount of FPEI inflows in many cases represents only a small percentage of the money supply.

13. It was found that FPEI increased the efficiency of domestic stock markets through exposure to the international environment and reduced the cost of capital for domestic companies by boosting market performance. However, FPEI could increase the volatility of domestic markets.

14. It is difficult to set standards for the desirable speed and sequence of capital market liberalisation across countries. However, there was a broad agreement on the merit of gradual opening of domestic stock markets to foreign investment.

Prospects for portfolio equity flows: the role of host and home countries

(a) Prospects

15. Emerging markets will continue to provide good diversification opportunities for global portfolio holders and, most likely, above-average risk-adjusted returns.

16. Due to demographic factors and economic liberalization, private pension funds have grown substantially in a number of OECD countries. Together with other institutional investors, such as insurance companies and mutual funds,

pension funds will continue to be an important source of capital for emerging markets.

17. Although recent trends in FPEI in emerging markets might have been partly driven by an international economic environment characterized by low world interest rates, a reversal of this situation is not likely to lead to large outflows of capital from emerging markets. It was recognized that institutional investors have a long-term investment perspective, and that they tend to adjust their exposure gradually in times of bearish markets, rather than pull out entirely.

18. Overall, it was agreed that prospects for sustainable FPEI flows are good, especially in view of the growth potential of recipient countries and the continuing progress made in increasing standards in emerging markets.

(b) Role of host countries

19. In order to sustain the international interest in emerging markets, Governments in host countries could take a number of steps including:

- Transparent government economic policies and commitment to a longer-term package of regulatory and market reform;

- Taxation policies which are fair and non-discriminatory for foreign investors;

- Appropriate investor protection;

- Improvement of the settlement system;

- Encouraging frequent, periodic disclosure of financial information;

- Fostering the improvement of accounting and auditing practices;

- Considering the possible introduction of financial derivatives markets.

(c) Role of home countries

20. Home countries could facilitate the future development of emerging markets by taking into account the following points:

- Allowing issues of securities in mature markets by emerging-market companies. Recent measures taken by the United States and Japan, which help improve the liquidity of privately-placed developing country securities, are a positive development.

- Relaxation of regulations imposing ceilings on the share of foreign assets in the portfolios of institutional investors.

Areas for further discussion

21. A number of issues were identified on which further intergovernmental discussion would be highly useful:

- Steps to be taken to accelerate the development of stock markets in developing countries, especially low-income countries and countries in transition;

- Appropriate market development (including the introduction of derivatives) and FPEI policies according to stages of economic development;

- Ways to improve listing procedures for small and medium-sized companies.

- Investment strategies of institutional investors and home countries' policies;

- Analysis of the impact of FPEI on exchange rates and on the volatility of domestic stock markets;

- Analysis of international accounting and disclosure rules.

Technical assistance

22. Participants suggested a few areas where technical assistance is needed:

- Advisory services for developing countries on appropriate policies and measures to develop and strengthen capital markets and attract FPEI.

- Seminars to be held at the country level on the role of FPEI in the mobilization of resources and on appropriate policies to develop domestic capital markets.

- Establishment of education and research centres to study the role of stock markets and their efficient functioning;

Private financing of infrastructure projects in developing countries with special emphasis on build-operate-transfer (BOT) arrangements

23. The seminar undertook an extensive review of the BOT concept and its variants, as well as the BOT structure, financial techniques and contractual arrangements. It also considered the question of project risk. The aspects of costs and financing were not sufficiently explored. The experiences of Turkey, Pakistan and the Philippines were illustrated.

24. The seminar also reviewed the main issues facing BOT projects in developing countries and countries in transition. In many of these countries, massive infrastructure investment requirements, coupled with government fiscal constraints, have led to a strong interest in BOT financing schemes. Among the main issues to be tackled are the need to restructure some utility sectors, the need for an improved regulatory environment, problems associated with demand risks and foreign exchange risks.

25. The enabling environment in the host country was judged to largely determine successful application of the BOT concept. The degree of development of the private sector and the legal and regulatory system was found to be particularly relevant in this context.

26. While BOT schemes have been applied in the transport, telecommunications, energy, water-treatment and waste-management sectors, other areas such as health and education could also lend themselves to the BOT technique.

27. Successful application of BOT techniques requires a thorough identification and evaluation of risks by both parties, i.e. the Government and the private operator.

28. Participants agreed that the contractual aspects of BOT projects were of great importance. Dispute settlement merited particular attention.

29. There was a general agreement that BOT techniques were of increasing importance to investment programmes in developing countries and countries in transition. However, there was concern that many of these countries, especially the low-income countries, were not adequately equipped to identify, design, negotiate, and implement BOT schemes in the absence of an appropriate policy framework, adequate guidelines and managerial capacity. Many countries would require technical support from international institutions to enable them to strengthen their policy framework and institutional capabilities. The forthcoming UNIDO guidelines on the development, negotiation and implementation of BOT projects were welcomed.

Chapter IV

ORGANIZATIONAL MATTERS

A. Opening of the session

30. The third session of the Ad Hoc Working Group was opened on 10 January 1994 by the Chairman.

B. Bureau of the Ad Hoc Working Group at its third session

31. The Bureau of the Ad Hoc Working Group at its third session was as at its second session, namely:

Chairman:	Mr. J.P. Huner	(Netherlands)
Vice-Chairmen:	Mr. S. Jamaluddin	(Bangladesh)
	Mr. F.A. Gomes	(Brazil)
	Mr. G. Blehy	(Côte d'Ivoire)
	Mr. R. Krzysków	(Poland)
	Mr. W.S. Haynes	(United States of America)
Rapporteur:	Mr. E. Mercado	(Mexico)

C. Adoption of the agenda and organization of work
(Agenda item 1)

32. At the opening plenary of its third session, the Ad Hoc Working Group adopted the provisional agenda for its third session (TD/B/WG.1/9), as follows:

1. Adoption of the agenda and organization of work

2. Consideration of host and home country policies to promote foreign direct investment

3. Multilateral measures to promote foreign direct investment

4. Portfolio equity investment and new financing mechanisms

5. Provisional agenda for the fourth session of the Ad Hoc Working Group

6. Other business

7. Adoption of the report of the Ad Hoc Working Group to the Board.

D. Provisional agenda for the fourth session of the Ad Hoc Working Group

(Agenda item 5)

[To be completed]

E. Other business

(Agenda item 6)

[To be completed]

F. Adoption of the report of the Ad Hoc Working Group to the Board

(Agenda item 7)

[To be completed]